



MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

To: Wood Miller, Chair
and Members of the Income and Franchise Tax Subcommittee

From: Lennie Collins, Chair
and Members of the Financial Institutions Workgroup

Date: July 15, 2010

Subject: Work Group Recommended Amendments to MTC Model Formula for the Apportionment and Allocation of the Net Income of Financial Institutions

The Workgroup has completed drafting all but one of the recommended amendments to the receipts factor portion of the MTC model financial institutions apportionment formula for the Subcommittee's consideration. The one remaining question is whether the rule should continue to provide a throwback to the taxpayer's commercial domicile or should be amended to instead provide a throwout (Section 3(p)). The recommended amendments, attached, reflect the Subcommittee's earlier policy direction.¹ The Workgroup proposes to begin drafting the property factor amendments directed by the Subcommittee once the Subcommittee is satisfied with the receipts factor amendments.

Background

In March 2009, the subcommittee adopted the following policy goals for the calculation of a financial institution's receipts factor.²

The overarching goal of the receipts factor should be to reflect the market.

- A. Receipts from ATM fees should be sourced to the location of the machine.
- B. Receipts from merchant discount should be sourced to the location of the merchant.
- C. The present regulation should be clarified to make clear that receipts from a financial institution's investments and trading assets and activities are meant to apply to a financial institution's own assets and activities, rather than the assets of third parties that are managed by the financial institution or to activities undertaken by the financial institution on behalf of third parties.

¹ A copy of the conceptual policy goals for financial institution apportionment is also attached.

² As a preliminary matter, the subcommittee determined that the current three factor formula in the present model should be retained, rather than moving to a single receipt factor apportionment formula.

D. Receipts from investment and trading assets and activities undertaken by a financial institution on behalf of third parties should be specified to reflect the market, except when doing so would likely lead to manipulation or when it would be unreasonably difficult for a financial institution to comply.

E. Receipts from activities that are not otherwise specifically addressed in the model should be addressed in a way that reasonably reflects the market. It should be noted that the financial industry representatives on the work group continue to recommend that such non-specified receipts should be sourced based on cost of performance.

Summary of proposed changes to model formula

- **Section 2. Definitions**

2(e). The definition of credit card was amended to eliminate separate references to travel or entertainment cards. The proposed definition will encompass such cards as they are included within the definition of any card that “entitles the holder to charge the cost of purchases, or a cash advance, against a line of credit.”

2 (g). This is a new provision that provides a definition for a debit card. Debit cards are not addressed in the current regulation.

2(k). The current reference to “properties treated as loans under Section 595 of the Federal Internal Revenue Code” has been eliminated, as Section 595 has been repealed. The work group concluded there was no continuing need for the reference.

Other changes were made to Section 2 definitions as necessary to be consistent with changes in section 3.

- **Section 3. Receipts Factor.**

3(d) and (e). The current reference to “interest and fees or penalties in the nature of interest from loans... ’ has been replaced with “interest, fees, and penalties imposed in connection with loans...” both for loans secured by real property and for loans that are not so secured.

3(g). Similarly, the current reference to “credit card receivables” has been eliminated, as the provision has been broadened to applied to all fees, interest and penalties charged to card holders, irrespective of the nature of the card. As in the case of Sections 3(d) and (e), the reference to fees or penalties “in the nature of interest” has been replaced with “fees, interest and penalties charged to credit, debit or similar card holders.”

3(i)(2). New language has been added to provide a formula for calculating the numerator of the receipts factor for debit card issuer’s reimbursement fees. Similarly, 3

(i)(3) provides a formula for all other card issuer's reimbursement fees, other than for credit card issuers – credit card issuers are addressed in 3 (i)(1) – and debit card issuers.

3(j). Provides a general rule for sourcing merchant discount to the location of the merchant. If the taxpayer cannot readily determine the location of the merchant, the rule provides a cascading series of proxies for calculating the numerator.

3(k). Provides that the receipts factor for ATM fees is sourced to the location of the cardholder's billing address if the card was issued by the taxpayer. If the card was issued by another financial institution, the taxpayer is to source the fees it charges to the location of the machine if it is owned or leased by the taxpayer.

3(l)(2). Provides that receipts from loan servicing fees for servicing the loans of another bank be sourced to the location of the borrower. State work group members would prefer to leave this provision as is. Industry work group members feel that the provision does not reflect market sourcing and would recommend these receipts be sourced to the location of the bank that purchased the services. If the purchasing bank is an affiliate, then Industry work group members would agree the receipts could continue to be sourced to the location of the borrower.

3(m). The draft contains four alternative proposals for sourcing receipts from services not otherwise specifically apportioned under Section 3. Industry work group members prefer **either** retaining the current rule (cost of performance) **or** deleting the catch all provision entirely. In the latter case, receipts would automatically fall under Section 3 (o) (all other receipts) and be sourced according to the state general rule for that type of service. State work group members prefer **either** deleting the catch all provision and sourcing the receipts under Section 3 (o) **or** amending the rule to provide two options. Option A would source in accordance with MTC Section 17, as amended. Option B would delete the provision and source the receipts under Section 3 (o).

3(n). Provides that income from the bank's own investment assets and activities and from trading assets and activities are included in the receipts factor, if they are reported on the taxpayer's financial statements, call reports, or similar reports.

Possible new section. In prior reports, the work group had recommended adding a specific sourcing rule for receipts from the bank's investment assets and activities and trading assets and activities performed on behalf of third parties (e.g., trust accounts). Ultimately, the State members of the work group felt the best approach was to allow these receipts to be sourced with all other receipts from services either in accordance with the rule that the MTC will adopt to replace cost of performance, or in accordance with the state's own (non-COP) rule. Industry members also did not recommend a specific rule for these types of receipts.

3(p). Provides that all receipts which would otherwise be assigned to a state in which the taxpayer is not taxable would be assigned to the taxpayer's commercial domicile. The State work group members are considering throwout as an alternative.

**Multistate Tax Commission
Financial Institutions Working Group**

RECOMMENDED AMENDMENTS

Formula for the Apportionment and Allocation of Net Income of Financial Institutions

*July 15, 2010
For Discussion Purposes Only*

Work Group Recommended Amendments, through Receipts Factor

Section 1. Apportionment and Allocation.

(a) Except as otherwise specifically provided, a financial institution whose business activity is taxable both within and without this state shall allocate and apportion its net income as provided in this [Act]. All items of nonbusiness income (income which is not includable in the apportionable income tax base) shall be allocated pursuant to the provisions of []. A financial institution organized under the laws of a foreign country, the Commonwealth of Puerto Rico, or a territory or possession of the United States whose effectively connected income (as defined under the Federal Internal Revenue Code) is taxable both within this state and within another state, other than the state in which it is organized, shall allocate and apportion its net income as provided in this [Act].

(b) All business income (income which is includable in the apportionable income tax base) shall be apportioned to this state by multiplying such income by the apportionment percentage. The apportionment percentage is determined by adding the taxpayer's receipts factor (as described in Section 3 of this article), property factor (as described in Section 4 of this article), and payroll factor (as described in Section 5 of this article) together and dividing the sum by three. If one of the factors is missing, the two remaining factors are added and the sum is divided by two. If two of the factors are missing, the remaining factor is the apportionment percentage. A factor is missing if both its numerator and denominator are zero, but it is not missing merely because its numerator is zero.

(c) Each factor shall be computed according to the method of accounting (cash or accrual basis) used by the taxpayer for the taxable year.

(d) If the allocation and apportionment provisions of this [Act] do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [State Tax Administrator] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of any one or more of the factors,
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or
- (4) the employment of any other method to effectuate an equitable allocation and

apportionment of the taxpayer's income.

Section 2. Definitions.

As used in this [Act], unless the context otherwise requires:

(a) "**Billing address**" means the location indicated in the books and records of the taxpayer on the first day of the taxable year (or on such later date in the taxable year when the customer relationship began) as the address where any notice, statement and/or bill relating to a customer's account is mailed.

(b) "**Borrower or credit card holder located in this state**" means:

- (1) a borrower, other than a credit card holder, that is engaged in a trade or business which maintains its commercial domicile in this state; or
- (2) a borrower that is not engaged in a trade or business or a credit card holder whose billing address is in this state.

(c) "**Commercial domicile**" means:

- (1) the headquarters of the trade or business, that is, the place from which the trade or business is principally managed and directed; or
- (2) if a taxpayer is organized under the laws of a foreign country, or of the Commonwealth of Puerto Rico, or any territory or possession of the United States, such taxpayer's commercial domicile shall be deemed for the purposes of this [Act] to be the state of the United States or the District of Columbia from which such taxpayer's trade or business in the United States is principally managed and directed. It shall be presumed, subject to rebuttal, that the location from which the taxpayer's trade or business is principally managed and directed is the state of the United States or the District of Columbia to which the greatest number of employees are regularly connected or out of which they are working, irrespective of where the services of such employees are performed, as of the last day of the taxable year.

(d) "**Compensation**" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services that are included in such employee's gross income under the Federal Internal Revenue Code. In the case of employees not subject to the Federal Internal Revenue Code, e.g., those employed in foreign countries, the determination of whether such payments would constitute gross income to such employees under the Federal Internal Revenue Code shall be made as though such employees were subject to the Federal Internal Revenue Code.

(e) "**Credit card**" means ~~credit, travel or entertainment card.~~ a card, or other means of providing information, that entitles the holder to charge the cost of purchases, or a cash advance, against a line of credit.

(f) "~~Credit card~~ Card issuer's reimbursement fee" means the fee a taxpayer receives from a merchant's bank because one of the persons to whom the taxpayer has issued a credit, ~~debit, or similar type of~~ card has charged merchandise or services to the ~~credit~~-card. [If these changes are accepted the section will need to be moved to keep alphabetical order.]

(g) "**Debit card**" means a card, or other means of providing information, that enables the holder to charge the cost of purchases, or a cash withdrawal, against the holder's bank account or a

remaining balance on the card.

(~~gh~~) "**Employee**" means, with respect to a particular taxpayer, any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee of that taxpayer.

(~~hi~~) "**Financial institution**" means: [insert state's definition here][*for a starting point for the development of a definition, see Appendix A*]

(~~ij~~) "**Gross rents**" means the actual sum of money or other consideration payable for the use or possession of property. "Gross rents" shall include, but not be limited to:

- (1) any amount payable for the use or possession of real property or tangible property whether designated as a fixed sum of money or as a percentage of receipts, profits or otherwise,
- (2) any amount payable as additional rent or in lieu of rent, such as interest, taxes, insurance, repairs or any other amount required to be paid by the terms of a lease or other arrangement, and
- (3) a proportionate part of the cost of any improvement to real property made by or on behalf of the taxpayer which reverts to the owner or lessor upon termination of a lease or other arrangement. The amount to be included in gross rents is the amount of amortization or depreciation allowed in computing the taxable income base for the taxable year. However, where a building is erected on leased land by or on behalf of the taxpayer, the value of the land is determined by multiplying the gross rent by eight and the value of the building is determined in the same manner as if owned by the taxpayer.
- (4) The following are not included in the term "gross rents":
 - (A) reasonable amounts payable as separate charges for water and electric service furnished by the lessor;
 - (B) reasonable amounts payable as service charges for janitorial services furnished by the lessor;
 - (C) reasonable amounts payable for storage, provided such amounts are payable for space not designated and not under the control of the taxpayer; and
 - (D) that portion of any rental payment which is applicable to the space subleased from the taxpayer and not used by it.

(~~jk~~) "**Loan**" means any extension of credit resulting from direct negotiations between the taxpayer and its customer, and/or the purchase, in whole or in part, of such extension of credit from another. Loans include participations, syndications, and leases treated as loans for federal income tax purposes. Loans shall not include: ~~properties treated as loans under Section 595 of the Federal Internal Revenue Code~~; futures or forward contracts; options; notional principal contracts such as swaps; credit card receivables, including purchased credit card relationships; non-interest bearing balances due from depository institutions; cash items in the process of collection; federal funds sold; securities purchased under agreements to resell; assets held in a trading account; securities; interests in a REMIC, or other mortgage-backed or asset-backed security; and other similar items.

(~~kl~~) "**Loan secured by real property**" means that fifty percent or more of the aggregate value of the collateral used to secure a loan or other obligation, when valued at fair market value as of the time the original loan or obligation was incurred, was real property.

(~~lm~~) **"Merchant discount"** means the fee (or negotiated discount) charged to a merchant by the taxpayer for the privilege of participating in a program whereby a credit, debit, or similar type of card is accepted in payment for merchandise or services sold to the card holder, net of any cardholder charge-back and unreduced by any interchange transaction or issuer reimbursement fee paid to another for charges or purchases made its cardholder.

(~~mn~~) **"Participation"** means an extension of credit in which an undivided ownership interest is held on a *pro rata* basis in a single loan or pool of loans and related collateral. In a loan participation, the credit originator initially makes the loan and then subsequently resells all or a portion of it to other lenders. The participation may or may not be known to the borrower.

(~~no~~) **"Person"** means an individual, estate, trust, partnership, corporation and any other business entity.

(~~op~~) **"Principal base of operations"** with respect to transportation property means the place of more or less permanent nature from which said property is regularly directed or controlled. With respect to an employee, the "principal base of operations" means the place of more or less permanent nature from which the employee regularly (1) starts his or her work and to which he or she customarily returns in order to receive instructions from his or her employer or (2) communicates with his or her customers or other persons, or (3) performs any other functions necessary to the exercise of his or her trade or profession at some other point or points.

(~~pq~~) **"Real property owned"** and **"tangible personal property owned"** mean real and tangible personal property, respectively, (1) on which the taxpayer may claim depreciation for federal income tax purposes, or (2) property to which the taxpayer holds legal title and on which no other person may claim depreciation for federal income tax purposes (or could claim depreciation if subject to federal income tax). Real and tangible personal property do not include coin, currency, or property acquired in lieu of or pursuant to a foreclosure.

(~~qr~~) **"Regular place of business"** means an office at which the taxpayer carries on its business in a regular and systematic manner and which is continuously maintained, occupied and used by employees of the taxpayer.

(~~rs~~) **"State"** means a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States or any foreign country.

(~~st~~) **"Syndication"** means an extension of credit in which two or more persons fund and each person is at risk only up to a specified percentage of the total extension of credit or up to a specified dollar amount.

(~~tu~~) **"Taxable"** means either:

(1) that a taxpayer is subject in another state to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, a corporate stock tax (including a bank shares tax), a single business tax, or an earned surplus tax, or any tax which is imposed upon or measured by gross or net income; or

(2) that another state has jurisdiction to subject the taxpayer to any of such taxes regardless of whether, in fact, the state does or does not.

(~~tv~~) **"Transportation property"** means vehicles and vessels capable of moving under their own power, such as aircraft, trains, water vessels and motor vehicles, as well as any equipment or containers attached to such property, such as rolling stock, barges, trailers or the like.

Section 3. Receipts Factor.

(a) **General.** The receipts factor is a fraction, the numerator of which is the receipts of the taxpayer in this state during the taxable year and the denominator of which is the receipts of the taxpayer within and without this state during the taxable year. The method of calculating receipts for purposes of the denominator is the same as the method used in determining receipts for purposes of the numerator. The receipts factor shall include only those receipts described herein which constitute business income and are included in the computation of the apportionable income base for the taxable year.

(b) **Receipts from the lease of real property.** The numerator of the receipts factor includes receipts from the lease or rental of real property owned by the taxpayer if the property is located within this state or receipts from the sublease of real property if the property is located within this state.

(c) **Receipts from the lease of tangible personal property.**

- (1) Except as described in paragraph (2) of this subsection, the numerator of the receipts factor includes receipts from the lease or rental of tangible personal property owned by the taxpayer if the property is located within this state when it is first placed in service by the lessee.
- (2) Receipts from the lease or rental of transportation property owned by the taxpayer are included in the numerator of the receipts factor to the extent that the property is used in this state. The extent an aircraft will be deemed to be used in this state and the amount of receipts that is to be included in the numerator of this state's receipts factor is determined by multiplying all the receipts from the lease or rental of the aircraft by a fraction, the numerator of which is the number of landings of the aircraft in this state and the denominator of which is the total number of landings of the aircraft. If the extent of the use of any transportation property within this state cannot be determined, then the property will be deemed to be used wholly in the state in which the property has its principal base of operations. A motor vehicle will be deemed to be used wholly in the state in which it is registered.

(d) **Interest, fees and penalties -from-imposed in connection with loans secured by real property.**

- (1) The numerator of the receipts factor includes interest, ~~and fees or penalties in the nature of interest fees, and penalties from-imposed in connection with~~ loans secured by real property if the property is located within this state. If the property is located both within this state and one or more other states, the receipts described in this subsection are included in the numerator of the receipts factor if more than fifty percent of the fair market value of the real property is located within this state. If more than fifty percent of the fair market value of the real property is not located within any one state, then the receipts described in this subsection shall be included in the numerator of the receipts factor if the borrower is located in this state.
- (2) The determination of whether the real property securing a loan is located within this state shall be made as of the time the original agreement was made and any and all

subsequent substitutions of collateral shall be disregarded.

(e) **Interest, fees, and penalties from imposed in connection with loans not secured by real property.** The numerator of the receipts factor includes interest, ~~and fees or penalties in the nature of interest~~ fees, and penalties from imposed in connection with loans not secured by real property if the borrower is located in this state.

(f) **Net gains from the sale of loans.** The numerator of the receipts factor includes net gains from the sale of loans. Net gains from the sale of loans includes income recorded under the coupon stripping rules of Section 1286 of the Internal Revenue Code.

- (1) The amount of net gains (but not less than zero) from the sale of loans secured by real property included in the numerator is determined by multiplying such net gains by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (d) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans secured by real property.
- (2) The amount of net gains (but not less than zero) from the sale of loans not secured by real property included in the numerator is determined by multiplying such net gains by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (e) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans not secured by real property.

(g) **Receipts from ~~credit card receivables~~ fees, interest, and penalties charged to card holders.** The numerator of the receipts factor includes fees, interest and ~~fees or penalties in the nature of interest from credit card receivables and receipts from fees~~ charged to credit, debit or similar card holders, ~~such as including but not limited to~~ annual fees, and overdraft fees, if the billing address of the card holder is in this state.

(h) **Net gains from the sale of credit card receivables.** The numerator of the receipts factor includes net gains (but not less than zero) from the sale of credit card receivables multiplied by a fraction, the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is the taxpayer's total amount of interest and fees or penalties in the nature of interest from credit card receivables and fees charged to card holders.

(i) **~~Credit card~~ Card issuer's reimbursement fees.** The numerator of the receipts factor includes

(1) all credit card issuer's reimbursement fees multiplied by a fraction, the numerator of which is the amount of fees, interest, and penalties charged to credit card holders included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is the taxpayer's total amount of ~~interest and fees or penalties in the nature of interest from credit card receivables and fees~~ fees, interest, and penalties charged to credit card holders.

(2) all debit card issuer's reimbursement fees multiplied by a fraction, the numerator of which is the amount of fees, interest, and penalties charged to debit card holders included in the numerator of the receipts factor pursuant to subsection (g) of this

section and the denominator of which is the taxpayer's total amount of fees, interest, and penalties charged to debit card holders.

(3) all other card issuer's reimbursement fees multiplied by a fraction, the numerator of which is the amount of fees, interest, and penalties charged to all other card holders included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is the taxpayer's total amount of fees, interest, and penalties charged to all other card holders

(j) Receipts from merchant discount.

(1) If the taxpayer can readily determine the location of the merchant and if the merchant is in this state, ~~The~~ the numerator of the receipts factor includes receipts from merchant discount, if the commercial domicile of the merchant is in this state. Such receipts shall be computed net of any cardholder charge backs, but shall not be reduced by any interchange transaction fees or by any issuer's reimbursement fees paid to another for charges made by its card holders.

(2) If the taxpayer cannot readily determine the location of the merchant, the numerator of the receipts factor includes such receipts from the merchant discount multiplied by a fraction:

(A) in the case of a merchant discount related to the use of a credit card, the numerator of which is the amount of fees, interest and penalties charged to credit card holders that is included in the numerator of the receipts factor pursuant to subsection (g) of this section and the denominator of which is the taxpayer's total amount of fees, interest and penalties charged to credit card holders, and

(B) in the case of a merchant discount related to the use of a debit card, the numerator of which is the amount of fees, interest and penalties charged to debit card holders that is included in the numerator of the receipts factor pursuant to subsection (g) of this section, and the denominator of which is the taxpayer's total amount of fees, interest and penalties charged to debit card holders.

(C) in the case of a merchant discount related to the use of all other types of cards, the numerator of which is the amount of fees, interest and penalties charged to all other card holders that is included in the numerator of the receipts factor pursuant to subsection (g) of this section, and the denominator of which is the taxpayer's total amount of fees, interest and penalties charged to all other card holders.

(3) The taxpayer's method for sourcing each receipt from a merchant discount must be consistently applied to such receipt in all states that have adopted sourcing methods substantially similar to subsections (1) and (2) of this section and must be used on all subsequent returns for sourcing receipts from such merchant unless the [State Tax Administrator] permits or requires application of the alternative method.

(k) Receipts from ATM fees. The receipts factor includes all ATM fees that are not forwarded directly to another bank.

(1) The numerator of the receipts factor includes fees charged to a cardholder for the use at an ATM of a card issued by the taxpayer if the cardholder's billing address is in this state.

(2) The numerator of the receipts factor includes fees charged to a cardholder, other than the taxpayer's cardholder, for the use of such card at an ATM owned or rented by the taxpayer, if the ATM is in this state.

(k) Loan servicing fees.

(1) (A) The numerator of the receipts factor includes loan servicing fees derived from loans secured by real property multiplied by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (d) of this section and the denominator of which is the total amount of interest, ~~and fees, or~~ and penalties in the nature of interest from loans secured by real property.

(B) The numerator of the receipts factor includes loan servicing fees derived from loans not secured by real property multiplied by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (e) of this section and the denominator of which is the total amount of interest, ~~and fees, or~~ and penalties in the nature of interest from loans not secured by real property.

(2) In circumstances in which the taxpayer receives loan servicing fees for servicing either the secured or the unsecured loans of another, the numerator of the receipts factor shall include such fees if the borrower is located in this state.

Industry Workgroup Member Preferred Alternative:

Source receipts from loan servicing to the location of the bank that purchased the services. If the purchasing bank is an affiliate, then source according to the current rule – to the location of the borrower.

State Workgroup Member Preferred Alternative.

Leave as is. Receipts would be sourced to location of borrower.

(lm) Receipts from services. The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section if the service is performed in this state. If the service is performed both within and without this state, the numerator of the receipts factor includes receipts from services not otherwise apportioned under this section, if a greater proportion of the income-producing activity is performed in this state based on cost of performance.

Industry Workgroup Member Preferred Alternatives:

Alternative 1: Leave as is. Receipts would be sourced according to COP.

Alternative 2: Delete. Receipts would automatically fall under (o) (all other receipts) and be sourced according to the state general rule for that type of receipt.

State Workgroup Member Preferred Alternatives.

Alternative 1: Delete. Receipts would automatically fall under (o) (all other receipts) and be sourced according to the state general rule for that type of receipt.

Alternative 2: Amend to provide two options. Option A would source in accordance with MTC section 17, as amended. Option B would delete the provision, in which case receipts would fall under (o) (all other receipts) and be sourced according to the state's general rule for service receipts.

“The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section if [Insert MTC proposed section 17 service sourcing, as amended. Alternatively, delete this section 3(m).]”

Note: Industry Workgroup members oppose the State Workgroup Alternative 2, reasoning that “this should be a model provision –not provide a menu from which the states can pick and choose how to source receipts; and selecting amended MTC section 17 before it is

completed and without review of application/relevance to the industry is injudicious.”

(~~mn~~) Receipts from the financial institution’s investment assets and activities-activity and trading assets and activitiesactivity.

- (1) Interest, dividends, net gains (but not less than zero) and other income from investment assets and activities and from trading assets and activities that are reported on the taxpayer’s financial statements, call reports, or similar reports shall be included in the receipts factor. Investment assets and activities and trading assets and activities include but are not limited to: investment securities; trading account assets; federal funds; securities purchased and sold under agreements to resell or repurchase; options; futures contracts; forward contracts; notional principal contracts such as swaps; equities; and foreign currency transactions. With respect to the investment and trading assets and activities described in subparagraphs (A) and (B) of this paragraph, the receipts factor shall include the amounts described in such subparagraphs.
 - (A) The receipts factor shall include the amount by which interest from federal funds sold and securities purchased under resale agreements exceeds interest expense on federal funds purchased and securities sold under repurchase agreements.
 - (B) The receipts factor shall include the amount by which interest, dividends, gains and other income from trading assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book, and foreign currency transactions, exceed amounts paid in lieu of interest, amounts paid in lieu of dividends, and losses from such assets and activities.
- (2) The numerator of the receipts factor includes interest, dividends, net gains (but not less than zero) and other income from investment assets and activities and from trading assets and activities described in paragraph (1) of this subsection that are attributable to this state.
 - (A) The amount of interest, dividends, net gains (but not less than zero) and other income from investment assets and activities in the investment account to be attributed to this state and included in the numerator is determined by multiplying all such income from such assets and activities by a fraction, the numerator of which is the average value of such assets which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the average value of all such assets.
 - (B) The amount of interest from federal funds sold and purchased and from securities purchased under resale agreements and securities sold under repurchase agreements attributable to this state and included in the numerator is determined by multiplying the amount described in subparagraph (A) of paragraph (1) of this subsection from such funds and such securities by a fraction, the numerator of which is the average value of federal funds sold and securities purchased under agreements to resell which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the average value of all such funds and such securities.
 - (C) The amount of interest, dividends, gains and other income from trading assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book and foreign currency transactions (but

excluding amounts described in subparagraphs (A) or (B) of this paragraph), attributable to this state and included in the numerator is determined by multiplying the amount described in subparagraph (B) of paragraph (1) of this subsection by a fraction, the numerator of which is the average value of such trading assets which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the average value of all such assets.

(D) For purposes of this paragraph, average value shall be determined using the rules for determining the average value of tangible personal property set forth in subsections (c) and (d) of Section 4.

(3) In lieu of using the method set forth in paragraph (2) of this subsection, the taxpayer may elect, or the [State Tax Administrator] may require in order to fairly represent the business activity of the taxpayer in this state, the use of the method set forth in this paragraph.

(A) The amount of interest, dividends, net gains (but not less than zero) and other income from investment assets and activities in the investment account to be attributed to this state and included in the numerator is determined by multiplying all such income from such assets and activities by a fraction, the numerator of which is the gross income from such assets and activities which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the gross income from all such assets and activities.

(B) The amount of interest from federal funds sold and purchased and from securities purchased under resale agreements and securities sold under repurchase agreements attributable to this state and included in the numerator is determined by multiplying the amount described in subparagraph (A) of paragraph (1) of this subsection from such funds and such securities by a fraction, the numerator of which is the gross income from such funds and such securities which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the gross income from all such funds and such securities.

(C) The amount of interest, dividends, gains and other income from trading assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book and foreign currency transactions (but excluding amounts described in subparagraphs (A) or (B) of this paragraph), attributable to this state and included in the numerator is determined by multiplying the amount described in subparagraph (B) of paragraph (1) of this subsection by a fraction, the numerator of which is the gross income from such trading assets and activities which are properly assigned to a regular place of business of the taxpayer within this state and the denominator of which is the gross income from all such assets and activities.

(4) If the taxpayer elects or is required by the [State Tax Administrator] to use the method set forth in paragraph (3) of this subsection, it shall use this method on all subsequent returns unless the taxpayer receives prior permission from the [State Tax Administrator] to use, or the [State Tax Administrator] requires a different method.

(5) The taxpayer shall have the burden of proving that an investment asset or activity or trading asset or activity was properly assigned to a regular place of business outside of this state by demonstrating that the day-to-day decisions regarding the asset or activity occurred at a regular place of business outside this state. Where the day-to-

day decisions regarding an investment asset or activity or trading asset or activity occur at more than one regular place of business and one such regular place of business is in this state and one such regular place of business is outside this state, such asset or activity shall be considered to be located at the regular place of business of the taxpayer where the investment or trading policies or guidelines with respect to the asset or activity are established. Unless the taxpayer demonstrates to the contrary, such policies and guidelines shall be presumed to be established at the commercial domicile of the taxpayer.

| **(nQ) All other receipts.** The numerator of the receipts factor includes all other receipts pursuant to the rules set forth in [insert your state's regular situsing rules for the receipts not covered by this section].

| **(ep) Attribution of certain receipts to commercial domicile.** All receipts which would be assigned under this section to a state in which the taxpayer is not taxable shall be included in the numerator of the receipts factor, if the taxpayer's commercial domicile is in this state.

| NOTE: The Workgroup is continuing discussion on (3)(p) regarding whether to unanimously recommend that the provision remain unchanged as a “throwback” to the taxpayer’s commercial domicile, or whether the State members of the Workgroup would like to make an alternative recommendation to “throwout” these receipts instead.



Working Together Since 1967 to Preserve Federalism and Tax Fairness

To: Wood Miller, Chair
Members of the MTC Income & Franchise Tax Uniformity Subcommittee

From: Financial Institutions Apportionment Work Group

Date: June 22, 2009

Subject: Work Group Recommendations

The MTC promulgated its model Financial Institutions Apportionment Rule in 1994. Twenty states adopted the model, in whole or in part.¹ Today, a number of those states are considering amendments that would move away from the model. In light of this movement, the Executive Committee directed the Income & Franchise Tax Uniformity Subcommittee to develop proposed amendments for the model. The Subcommittee created the Financial Institutions Apportionment work group to review the model, identify problem areas and recommend amendments. The purpose of this memo is to provide the Subcommittee with the Work Group's list of identified issues and recommended conceptual amendments to address those issues.

The memo incorporates the consensus recommendations that the work group has developed. In addition, the memo notes two issues for which the Work Group has not been able to reach a consensus recommendation -- the sourcing of receipts from trust accounts and the sourcing of receipts from transactions that are not otherwise specifically covered by the rule. A discussion of the possible options for those issues is included.

I. The Sales Factor:

State Members Overarching goals –reflect the market

Industry Members Overarching Goals - (1) Each receipt should only be included in the sales factor numerator of one state (i.e., the sum of all of the states' receipts factors should not exceed 100%); (2) Current receipts sourcing should not be changed if it will result in immediate double taxation; (3) Receipts from services should be sourced in the same manner that such receipts would be sourced for non-financial organizations; (4) Incidental receipts should NOT be

¹ The states are AL, AR, CA, CO, HI, ID, KY, MA, MD, ME, MS, ND, NH, NM, KS, NH, OH, OR, RI, WA

changed to market sourcing; (5) All receipts should be included in the denominator of the sales factor; (6) Sourcing methods should be practical, not overly burdensome and readily available without programming changes; and (7) No revisions should be considered that cannot likely achieve actual adoption in a majority of the states, since adoption by only a few states of the approximately 20 states would create an environment that is less consistent and uniform than exists today.

A. ATM Fees

Current rule:

There is no current rule that specifically governs the sourcing of receipts from ATM fees. Instead, these receipts are currently sourced under Section 3(l), as are all receipts from services not otherwise apportioned under the rule. Section 3(l) currently provides;

(l) Receipts from services. The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section if the service is performed in this state. If the service is performed both within and without this state, the numerator of the receipts factor includes receipts from services not otherwise apportioned under this section, if a greater proportion of the income-producing activity is performed in this state based on cost of performance.

Problem to be addressed: Under the current greater COP sourcing rule, ATM fees are sourced to the production state, rather than to the market state.

Possible solutions:

- Source to the location of the ATM machines.
- Source to states where the transaction processing takes place.

Recommended solution: Add a new section to source ATM receipts to the location of the machines in order to better reflect the location of the market. This appears to be the most logical and easily administrable solution. The locations of the machines should be readily determinable from the taxpayer's records. Sourcing to states where the transaction processing takes place may not reflect the location of the market for these services.

Industry participants realize that the recommended solution does not meet our goals in that it likely will result in more than 100% of ATM fees being included in the numerator of more than one state's receipts factors and result in immediate double taxation for institutions where the processing activity is located in states that apply a greater COP sourcing rule. Nevertheless, since the information on ATM location is available and the percentages of fees are small, the industry participants conceded to this recommendation.

B. Merchant Discount, §3(j)

Current rule:

(j) Receipts from merchant discount. The numerator of the receipts factor includes

receipts from merchant discount if the commercial domicile of the merchant is in this state. Such receipts shall be computed net of any cardholder charge backs, but shall not be reduced by any interchange transaction fees or by any issuer's reimbursement fees paid to another for charges made by its card holders.

Problem to be addressed: The commercial domicile of the merchant is generally unknown and may not accurately reflect the market.

Possible solutions:

- Source merchant discount to the local location of the merchant at which the credit card transaction occurred.
- Source merchant discount to the location of the merchant bank.
- Source merchant discount on the basis of the ratio used to source interest and fees from credit card receivables.
- Source based on cost of performance.

Recommended solution: The working group recommends that merchant discount be sourced to the location of the merchant, if the financial institution has readily available information as to that location. Otherwise, source merchant discount based on the ratio used to source interest and fees from credit card receivables. The choice would be applied uniformly by the taxpayer in all states that have adopted the MTC financial institutions apportionment provision in which the taxpayer is doing business. Note, this credit card interest income proxy is similar to that in use in the model provision for apportioning credit card issuer's reimbursement fees.

Ideally, sourcing merchant discount to the location of the merchant should in all instances accurately reflect the financial institution's merchant discount market. But financial institutions do not necessarily know the merchant's location especially for Big Box Retailers, as it is not necessary for the financial institution to capture that information in order to properly account for merchant discount incurred as a result of use of an issuing bank's credit cards. The proposed default rule should be a fairly accurate predictor of the merchant's location, as it is reasonable that a credit card holder would use his card at a local merchant in a large number, if not a majority, of cases. In such cases, the location of the merchant discount market is the same as the market for credit card receivables – the location of the card user.

C. Receipts From Investment and Trading Assets and Activities, §3(m)

Current rule:

(m) Receipts from investment assets and activities and trading assets and activities.
(1) Interest, dividends, net gains (but not less than zero) and other income from investment assets and activities and from trading assets and activities shall be included in the receipts factor. Investment assets and activities and trading assets and activities include but are not limited to: investment securities; trading account assets; federal funds; securities purchased and sold under agreements to resell or repurchase; options; futures contracts; forward contracts; notional principal contracts such as swaps; equities; and foreign currency transactions. With respect to the investment and trading

assets and activities described in subparagraphs (A) and (B) of this paragraph, the receipts factor shall include the amounts described in such subparagraphs.
[REMAINDER OF RULE OMITTED]

Problem to be addressed: In developing the original apportionment provision, Sec. 3(m) was intended to cover income from investment assets and trading assets that are reflected in the financial institution's call report. However, the provision does not specifically limit its application to those assets/activities and at least one state noted that a taxpayer had suggested that Sec. 3(m) should cover fees related to investment activities conducted on behalf of its customers.

Recommended solution: Clarify the rule to state explicitly that it includes income from investment and trading assets reflected on the financial institution's call report or similar regulatory report or that would be required to be reported on such report if the taxpayer were a regulated financial institution. As an alternative, modify Sec. 3(m) to specifically provide that it does not cover fees received from conducting investment services for customers.

D. Receipts From Investment and Trading Assets and Activities on Behalf of 3d Party (trust accounts).²

Current rule: As is currently the case with receipts from ATM fees, these receipts currently fall under the rule for unspecified service receipts (§3(l)), which are sourced based on the greater cost of performance.

Problem to be addressed: Under the current greater COP sourcing rule such trust fees are sourced to the production state, rather than to the market state.

Possible solutions: There are a number of ways that these receipts can appropriately be sourced. The goal should be to reflect the market, unless the market is too easily manipulable or it is unreasonably difficult for financial institutions to comply. Possible sourcing rules include;

- Location of trust assets
- Location where the trust was formed
- Location of the trustee(s)
- Location of the trustor(s)
- Location of the trust office
- Location of beneficiaries, or
- Using a proxy for the location of the trust. Trust receipts could be apportioned on the basis of a formula that assigns shares of total trust receipts to each state in proportion to the ratio of deposits in that state to total deposits of the institution.

² The discussion of income from trust accounts in the text is not meant to imply that trust accounts are the only source of income from investment activity undertaken on behalf of a third party. To the extent that a financial institution receives income from such investment activity, such income would currently be subject to the same COP sourcing rule as income from trust accounts and would therefore also not reflect the market for the investment activity.

- Source under §3(l) as “receipts from services” that are “not otherwise apportioned.”

Recommended solution: At the present time, the state members of the work group have not reached a consensus on a recommended solution. Industry participants would prefer to maintain the existing sourcing rules of §3(l) which would retain the greater cost of performance rule for receipts from services because a change to market sourcing will result in immediate double taxation, be burdensome, and require significant programming. In the alternative, industry participants would prefer that such service receipts be sourced in the same manner as such receipts are sourced for non-financial organizations in order that there is a level playing field. Also, a state representative on the workgroup has suggested studying the Uniform Trust Act to see if the Act would assist the workgroup in formulating an appropriate sourcing rule.³

E. Non-specified Service Receipts, Other Non-Specified Receipts, and Attribution of certain receipts to commercial domicile, §§3(l), (n) and (o).

Current rules:

(l) Receipts from services. The numerator of the receipts factor includes receipts from services not otherwise apportioned under this section if the service is performed in this state. If the service is performed both within and without this state, the numerator of the receipts factor includes receipts from services not otherwise apportioned under this section, if a greater proportion of the income-producing activity is performed in this state based on cost of performance.

(n) All other receipts. The numerator of the receipts factor includes all other receipts pursuant to the rules set forth in [insert your state's regular situsing rules for the receipts not covered by this section].

(o) Attribution of certain receipts to commercial domicile. All receipts which would be assigned under this section to a state in which the taxpayer is not taxable shall be included in the numerator of the receipts factor, if the taxpayer's commercial domicile is in this state.

Problem to be addressed: Under the current greater COP sourcing rule provided in (l), receipts from other services are sourced to the production state, rather than to the

³ The Uniform Trust Code includes a provision for establishing and transferring a trust's "principal place of administration" and an optional provision that establishes venue for judicial actions involving a trust. Briefly, Section 108 of the Code will give effect to the terms of a trust designating the principal place of administration if a trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction or all or part of the administration occurs in the designated jurisdiction. Section 108 allows the trustee to change the place of administration to any place, inside or outside the United States, as long as that place is appropriate to the trust's purposes, its administration, and the interests of the beneficiaries. Section 204 of the Code establishes venue for judicial actions involving a trust in the county of the State in which the trust's principal place of administration is or is to be located and, if the trust is created by will and the estate is still open, in the county in which the decedent's estate is being administered. There are additional venue rules if the trust has no trustee. As of April 28, 2008, twenty-one states have enacted the Uniform Trust Code. Copies of Sections 108 and 204 are contained in an Appendix to this memo, along with NCCUSL's comments to those sections.

market state. In addition, there is no exception for determining sourcing for the receipts that fall within a specific sourcing rule, but that are below a *de minimus* amount. Receipts from fees for administering 3rd party trust accounts are an example. This could result in needless administrative cost and complexity, both for financial institutions and for tax administrators.

Possible solutions:

- Retain the existing rules: source receipts from services that are not otherwise explicitly sourced using greater cost of performance, and source receipts from all other transactions that are not explicitly sourced using the state's general apportionment rules.
- Receipts from services that are not otherwise explicitly sourced could be sourced in the same proportion as all other receipts are sourced.
- In addition, a *de minimis* rule could be established to allow similar treatment for receipts that would normally be sourced according to a specific rule, but that fall below a threshold percentage of total receipts.
- Eliminate (l) (i.e., greater COP sourcing for other services) and thus provide that under (n) all other services are sourced in accordance with the state's general apportionment rule applicable to other industries.

Recommended solution: At the present time, the work group has not reached a consensus on a recommended solution. The state members of the work group recommend that receipts from services that are not explicitly sourced be sourced in the same proportion as all other receipts or simply not included in the factor. In addition, the state members recommend similarly sourcing specified receipts that fall below 1% of total receipts. Industry participants do not agree with the states' proposal and would prefer to maintain the existing sourcing rules of §§3(l) and (n). This would retain the greater cost of performance rule for receipts from services and source other receipts in the same manner as services for other taxpayers are sourced. In the alternative, industry participants would prefer that other service receipts be sourced in the same manner as such receipts are sourced for non-financial organizations (i.e., expanding (n) to include other services).

One state representative (not a member of the work group) suggested during the March uniformity committee meetings that receipts from loan origination fees should be specifically included in receipts sourced pursuant to Section 3 (d) of the rule (fees in the nature of interest). This would make clear that these receipts are to be sourced to the market. This suggestion was raised again at the June teleconference. It has not been vetted by the work group. Industry notes that not all fees connected to loans secured by real property are in the nature of interest and therefore the COP sourcing rule should be retained.⁴

⁴ In considering what fees should be encompassed within the definition of "loan origination fees", staff suggests that it might be useful for the workgroup to examine the HUD-1 Settlement Statement. The HUD-1 separately lists all fees imposed in connection with a loan secured by a mortgage on real property. The fees listed include fees paid to the lender, such as discount points, origination points and loan application fees. In addition, fees paid to third parties, such as appraisal fees, credit report fees and title search and title insurance fees are separately broken out. Discount points are considered prepaid interest and therefore deductible from taxable income over the life of the loan, to the same extent that post-closing interest on mortgage loans is ordinarily deductible. Origination points, although expressed

F. RICS and REMICs: the work group will take up the issue of sourcing receipts from RICs and REMICs at the end of the project.

II. The Property Factor: State and Industry Members Overarching goal – the intent is not to recreate the 1994 apportionment outcome of sourcing property to particular states. Rather, the intent is to attempt to maintain the 1994 policy of sourcing property to location of loan activity.

Current rules:

§4(g) Location of loans

(1) (A) A loan is considered to be located within this state if it is properly assigned to a regular place of business of the taxpayer within this state.

(B) A loan is properly assigned to the regular place of business with which it has a preponderance of substantive contacts....

(3) To determine the state in which the preponderance of substantive contacts relating to a loan have occurred, the facts and circumstances regarding the loan at issue shall be reviewed on a case-by-case basis and consideration shall be given to such activities as the solicitation, investigation, negotiation, approval and administration of the loan [SINAA]....

[REMAINDER OF RULE OMITTED]

...

§4(i) Period for which properly assigned loan remains assigned. A loan that has been properly assigned to a state shall, absent any change of material fact, remain assigned to said state for the length of the original term of the loan. Thereafter, said loan may be properly assigned to another state if said loan has a preponderance of substantive contact to a regular place of business there.

Problems to be addressed: Under the current loan location rule, it is not clear whether the SINAA factors are of equal weight or, conversely, whether the large presence of one factor can outweigh the absence of other SINAA factors. As a result, it is unclear both to tax administrators and to financial institutions, how the SINAA factors should be applied in individual cases. While industry participants noted that some clarification would be helpful, they did indicate that with the exception of a

in terms of a percentage of the loan amount, are considered fees for the lender's services in originating the loan and therefore are not deductible as interest. Nor are loan application fees properly classified as a "fee in the nature of interest." Staff suggests that it therefore might be more appropriate to consider receipts from all fees charged in connection with a loan secured by real property as service fees under Section 3(k). This suggestion has also not been vetted by the work group. Whether the fees are included in Section 3(d) or 3(k), the result would be the same – they would be sourced to the market. A copy of the HUD-1 is attached hereto as an Appendix.

couple of states they are not encountering significant problems with the current SINAA sourcing provision.

In addition, the term “change of material fact” in the loan assignment rule is undefined. A question has arisen as to whether the sale of a loan or pool of loans to another entity within the same controlled group of corporations as the seller constitutes a material change of fact. Both taxpayers and tax administrators would benefit from the inclusion of objective criteria to determine when there has been a material change of fact.

Recommended solution: California has proposed, and the work group recommends, a solution to both issues. As for the location of a loan, California would assign the loan to the state in which the preponderance of substantive contacts related to the loan occurred. Loans would be grouped by classes of like instruments. The costs associated with each activity for the loan or group of loans would then be determined. The state with the highest costs incurred will be the state to which the loans are assigned. The work group realizes that there are a significant number of details that need to be thought through and worked out (especially the definition of costs). In working through those issues, the overall goal will be to provide clarity in determining to which state(s) the loans should be sourced while retaining the intended production-state sourcing for loans in the property factor.

In addition, a special rule would be provided for automated loans programs. If the preponderance of substantive contacts are performed primarily through the use of automated systems, such as computerized investigation and approval processes, the loans shall be assigned to the location of the automated systems.

As to the definition of “change of material fact”, language would be added to indicate that a sale of loans within the same controlled group of corporations shall not, by itself, constitute a material change of fact. Section 1563(a)(1) of the Internal Revenue Code would be used to determine the members of a controlled group, substituting a “more than 50 percent” ownership test for the “at least 80 percent” test in the statute. Industry workgroup representatives suggest that the rule should create a rebuttable presumption that such loan sales do not constitute a material change of fact rather than a conclusive principle of law applicable in all such cases.

III. Definition of a Financial Institution, subject to the model provision: State Members Overarching goal – Uniform applicability of the rule to entities that are engaged in similar activity.

The work group recommends retaining the focus of the rule on financial institutions rather than on financial activity. In fact, Appendix A to the model defines financial institution to include entities (other than an insurance company, real estate broker, or securities dealer) that derive more than 50% of their gross income from activities that a financial institution is authorized to transact. Thus, the work group recommends retaining the definition of “financial institution” in Appendix A. Other specified institutions that are currently known to be heavily engaged in financial activity, such as investment banks, should be added to the definition, if not already included.